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Federal Communications Commission
Office of Secretary

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
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Revisions to Cable Television Rate Regulations	)	MB Docket No. 02-144
	)	
Implementation of Sections of The Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 92-266 MM Docket No. 93-215
	)	CS Docket No. 94-28
Adoption of a Uniform Accounting System for the Provision of Regulated Cable Service	)	CS Docket No. 96-157
Cable Pricing Flexibility	)	

To: The Commission

SUPPLEMENTAL REPLY COMMENTS OF
THE NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION

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To: The Commission

SUPPLEMENTAL REPLY COMMENTS OF THE NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION

The National Cable & Telecommunications Association ("NCTA"), by its attorneys, hereby submits these supplemental reply comments in connection with the letter and report (the "NATOA Report") dated October 7, 2004 in the above-referenced proceeding (the "*NPRM*")[1] submitted by the National Association of Telecommunications Officers and Advisors ("NATOA").

NCTA is the principal trade association of the cable television industry in the United States. Its members include owners and operators of cable television systems serving more than ninety percent of the nation's cable customers, as well as more than 200 program networks. NCTA has participated in dozens of proceedings implementing the cable television rate regulation provisions of the 1992 Cable Act and the Telecommunications Act of 1996.

[1] Revisions to Cable Television Rate Regulations, *Notice of Proposed Rulemaking and Order*, 17 FCC Rcd 11550 (released June 19, 2002), 67 Fed. Reg. 56882 (Sept. 5, 2002); *Order*, 17 FCC Rcd 15974 (released August 14, 2002), 67 Fed. Reg. 56880 (Sept. 5, 2002) (collectively, the "*NPRM*").

Many of NCTA's members have filed or intend to file FCC Forms 1235 pursuant to the Commission's rate regulations and therefore have a direct interest in the Commission's resolution of the issues raised in the NPRM, the Cox Comments, and the NATOA Report.

Introduction and Summary

The FCC Form 1235 Abbreviated Cost of Service Filing for Cable Network Upgrades provides a mechanism for cable operators to recover a portion of the cost of significant upgrades in regulated basic service tier rates. NCTA's initial comments explained that the need for this abbreviated cost of service option remains, given the significant upgrades many operators have undertaken since the FCC established its benchmark rates.[2]

The NATOA Report purported to respond to supplemental comments dated May 19, 2004 by Cox Communications, Inc. (the "Cox Comments"), which concerned regulatory review periods applicable to network upgrade rate calculations filed by cable operators on FCC Form 1235 pursuant to Section 76.922(j) of the Commission's rules. Specifically, Cox asked the FCC to clarify that the Commission's existing rules do not permit automatic tolling or unlimited review periods for FCC Form 1235 filings. It also asked the Commission to provide a uniform review period for all the various rate regulation forms that cable operators may file (FCC Forms 1200, 1205, 1210, 1220, 1230, 1235, and 1240).[3]

The NATOA Report does not respond to the issues raised in the Cox Comments. Instead, NATOA essentially seeks either to eliminate entirely or eviscerate the Commission's streamlined network upgrade rate rule. It proposes to significantly undermine the usefulness of the Form 1235 by "reduc[ing] the eligibility . . . to operators completing only analog video

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[2] NCTA Comments at 18.

[3] The Cox Comments also demonstrated that the Commission's streamlined network rate adjustment option (Form 1235) continues to meet important needs because, among other things, under the existing benchmark and price cap regulations cable operators otherwise are unable to recover as "external costs" the properly allocable portion of substantial costs entailed by cable system upgrades that in many cases are required under cable television franchise agreements. Cox Comments at 2.

system upgrades,"[4] or otherwise modifying it in a manner that will either discourage its use or prevent operators from recovering a fairly allocable portion of upgrade costs in regulated rates.[5]

The Commission should reject NATOA's proposals. Among other things, they are facially inconsistent with congressional policies implemented in the Commission's rules and fundamentally unfair to cable operators who relied upon Commission rules and invested to upgrade their service offerings and to improve basic cable services. Moreover, the Commission specifically created the Form 1235 as a "one-time" filing to address its previous decision that significant upgrade costs could not be incorporated in regulated rates under the Commission's benchmark regulations, even where such upgrades were required by local regulators.[6] If the Commission were to adopt NATOA's suggestion that the streamlined network upgrade option be eliminated, therefore, the Commission would be obligated under the Act to revisit its previous determination and to allow a fairly allocable portion of upgrade costs to be recovered in regulated BST "benchmark" rates.[7] This could only further complicate an already complex regulatory regime.

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[4] NATOA Report at 3.

[5] NATOA Report, Summary at 3.

[6] *See Rate Order*, 8 FCC Rcd at 5791-92, n.608; Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking*, 9 FCC Rcd 1164, 1216 (1993) ("*First Reconsideration Order*"); Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *Second Order on Reconsideration , Fourth Report and Order, and Fifth Notice of Proposed Rulemaking*, 9 FCC Rcd 4119, 4240-41, n.340 (1994) ("*Second Reconsideration Order*"); Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, *Report and Order and Further Notice of Proposed Rulemaking*, 9 FCC Rcd 4527, 4674-76 (1994) ("*Cost Order*").

[7] *See* 47 U.S.C. § 543(b)(2). Congress directed that the Commission's rate regulations be designed to "reduce administrative burdens on subscribers, cable operators, franchising authorities, and the Commission," 47 U.S.C. § 543(b)(2)(A), and that such regulations take into account, among other things, "the direct costs . . . of obtaining, transmitting, and otherwise providing signals carried on the basic service tier" and the "portion of the joint and common costs . . . to be reasonably and properly allocable to the basic service tier," 47 U.S.C. § 543(b)(2)(C).

As the Commission has acknowledged, its streamlined network upgrade option continues to serve important purposes that are not addressed by other provisions of the Commission's rate regulations.[8] The proposals outlined in the NATOA Report, on the other hand, would dramatically increase the administrative burdens of rate regulation, unfairly deny operators the ability to recover a fair share of upgrade costs in regulated BST rates, and conflict with Generally Accepted Accounting Principles ("GAAP") and the Commission's well established cost allocation rules. The Commission should therefore adopt the practical approach reflected in the Cox Comments, maintain the Commission's streamlined network upgrade option, and reject NATOA's proposals.

Discussion

I. The FCC Form 1235 Serves Congressionally Mandated Purposes that the Commission Would Otherwise be Forced to Address in its Benchmark Rate Regulations.

The 1992 Cable Act[9] and the Commission's initial rate regulation proceeding articulate several guiding principles applicable to cable television regulation generally and rate regulation in particular: (i) "to reduce administrative burdens on subscribers, cable operators, franchising authorities, and the Commission";[10] (ii) to "ensure that cable operators continue to expand,

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[8] *See* Carriage of Digital Television Broadcast Signals, *First Report and Order and Further Notice of Proposed Rulemaking*, 16 FCC Rcd 2598, 2638 at para. 106 (2001) ("*Digital Must Carry Order*") (finding that the goals of the network upgrade option "are as relevant now as they were in 1994" and extending the FCC Form 1235 to cover costs associated with the carriage of digital broadcast signals).

[9] The Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992) (the "1992 Cable Act").

[10] 47 U.S.C. § 543(b)(2)(A); *see, e.g.*, Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *Report and Order and Further Notice of Proposed Rulemaking*, 8 FCC Rcd 5631, 5638 (1993) ("*Rate Order*") (one purpose of the Cable Act was to minimize unnecessary regulation that would impose an undue burden on cable systems), *id.* at 5639 (Congress intended that regulations governing cable rates be designed to reduce administrative burdens on subscribers, cable operators, franchises and Commission), 5688 (permitting joint certification to ease regulatory burden on cable operators); H.R. CONF. REP. NO. 102-862, at 62 (1992) ("in prescribing regulations to ensure that rates are reasonable, the FCC shall seek to reduce administrative burdens on subscribers, cable operators, franchising authorities, and the Commission").

where economically justified";[11] and (iii) to "rely on the marketplace, to the maximum extent feasible"[12] to achieve these objectives. Consistent with these principles, the FCC Form 1235 reduces the administrative burdens of rate regulation[13] while taking into account "the direct costs . . . of obtaining, transmitting, and otherwise providing signals carried on the basic service tier" and the "portion of the joint and common costs . . . to be reasonably and properly allocable to the basic service tier."[14] NATOA tries to suggest that the form has outlived its usefulness, based on its mistaken belief that Form 1235 was created "in response to cable industry complaints that there were too few incentives in the regulatory scheme" to provide additional channels.[15] But an examination of the history of Form 1235's adoption shows it remains relevant and necessary today.

The Commission explicitly adopted its streamlined network upgrade option in 1994 "to implement the goals of the Cable Act of 1992, to promote the availability of diverse cable services and facilities, encourage economically justified upgrades, and reduce regulatory burdens, while ensuring reasonable rates for regulated cable services."[16] Among other things, the Commission's adoption of the streamlined network upgrade option was necessitated by the FCC's earlier determination not to permit external cost treatment of system rebuilds and upgrades under the standard "benchmark" regulations.

In its initial *Rate Order*, the Commission declined to permit external treatment of upgrade costs because, among other things, it believed that such significant costs likely would

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[11] 1992 Cable Act, § 2(b)(3), 106 Stat. 1463.

[12] *Id.*, § 2(b)(2), 106 Stat. 1463.

[13] 47 U.S.C. § 543(b)(2)(A).

[14] 47 U.S.C. § 543(b)(2)(C).

[15] NATOA Report at 4. Contrary to its current position, NATOA "support[ed] the objective of an abbreviated cost-of-service showing for significant prospective capital expenditures." *Cost Order*, 9 FCC Rcd at 4673, ¶ 282.

[16] *Cost Order*, 9 FCC Rcd at 4674-75, ¶ 285.

lead to increased rates.[17] The Commission determined, however, that it would "monitor the effects of treating network improvement costs this way and, if it appears that this treatment is thwarting the development of new technologies and services, will review our decision as necessary."[18] The Commission later noted that it would "continue to explore the feasibility of modifying the benchmark to include an upgrade variable."[19] The FCC also found "that passing-through upgrade costs may well be appropriate where such upgrades are required under the franchise. Local authorities presumably are in a position to weigh the potential impact of any cost increases on subscribers at the time they require system changes."[20]

Shortly thereafter, however, the Commission adopted its streamlined network upgrade option in its cost-of-service proceeding, which allowed operators to include certain upgrade expenses in basic rates without requiring an overly burdensome full cost-of-service showing.[21] The Commission limited its applicability to "significant upgrades requiring added capital investment, such as bandwidth capacity and conversion to fiber optics, and for system rebuilds."[22] Once the FCC Form 1235 was adopted, the Commission found it unnecessary to afford external cost treatment to upgrade expenses.[23]

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[17] *Rate Order*, 8 FCC Rcd at 5791, n.608. The Commission also noted that its existing benchmark regulations already permitted increases for the addition of channels that likely would result from an upgrade, but that those regulations did not address potential reductions in maintenance or other service expenses that an upgrade might make possible.

[18] *Id.* In the *First Reconsideration Order*, the Commission reviewed its initial decision and again declined to permit external treatment of upgrade costs. In addition to the increased cable rates that it believed would result from such treatment, the Commission declined external treatment because its benchmark methodology did not include an upgrade variable, 9 FCC Rcd at 1251, n.259, and because the Commission's cost-of-service proceeding was then in the process of "examining streamlined treatment of upgrade costs. . . . [which] could provide a treatment of upgrade expenditures substantially similar to external treatment." *Id.*, 9 FCC Rcd at 1216-17, ¶ 97.

[19] *Id.*, 9 FCC Rcd at 1251, n.259.

[20] *Id.*, 9 FCC Rcd at 1216, n.160 (citing the statutory requirement in 47 U.S.C. § 543(b)(4) that the Commission take into account the costs of satisfying franchise requirements). The Commission sought further comment on this point. *Id.*, 9 FCC Rcd at 1251-52, ¶¶ 153-54.

[21] *Cost Order*, 9 FCC Rcd at 4672-76, ¶¶ 280-291.

[22] FCC Form 1235 Instructions at 1; *Cost Order*, 9 FCC Rcd at 4674-76.

[23] *See Second Reconsideration Order*, 9 FCC Rcd at 4241, n.340; Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *Thirteenth Order on*

(continued . . .)

NATOA's proposal to eliminate the Commission's network upgrade option ignores these reasons for its adoption. As noted above, because the Commission expressly adopted the FCC Form 1235 in lieu of providing for external cost treatment of upgrade expenses under the benchmark regulations, the Commission would be obligated to revisit those regulations and provide for such external cost treatment if the NATOA proposal were adopted. This factor independently supports continued use of the streamlined network upgrade option. Moreover, the Commission has recently acknowledged that the "original goals of the [network upgrade option] . . . are as relevant now as they were in 1994," and in fact extended the use of FCC Form 1235 to incorporate costs associated with the carriage of digital broadcast signals.[24] The Commission, therefore, has already decided that the network upgrade option continues to meet important needs.

NATOA provides no evidence that use of the streamlined network upgrade option has led to abuses that warrant its elimination. In fact, the Commission's FCC Form 1235 has been serving the purposes for which it was created eight years ago. Cable operators have undertaken many significant system upgrades since 1996, and reasonably relied upon their ability to recover a properly allocable portion of upgrade costs in regulated rates when they planned and executed system upgrades. Those systems that have not yet upgraded should similarly be able to rely on recovery of these costs without engaging in a lengthy and expensive cost-of-service showing. Reliance interests aside, eliminating the option of a streamlined upgrade filing would impose substantial and unnecessary burdens on the Commission and cable industry. The Commission, therefore, should adopt the sensible procedural modifications suggested in the Cox Comments and reject NATOA's proposal.

(. . . *continued*)
Reconsideration, 11 FCC Rcd 388, 442 at n.230 (1995) (rejecting petitions for reconsideration advocating for the external treatment of upgrade costs under the benchmark rules).

[24] *Digital Must Carry Order*, 16 FCC Rcd at 2638, paras. 106-109. 47 C.F.R. § 76.922(j).

II. NATOA's Proposed FCC Form 1235 Revisions are Either Inconsistent with Congressional and Commission Policies or are Already Addressed by the Commission's Network Upgrade Methodology.

NATOA also points to a variety of perceived flaws in the working of the Form 1235. Most fundamentally, it argues that basic customers should not pay for upgrades that allow operators to offer unregulated services.[25] But NATOA misperceives the benefits of system upgrades enjoyed by basic service customers. Those customers receive improvements in their cable service in addition to newly-added basic channels, access to video-on-demand, and a variety of other advanced services such as electronic program guides. As the Commission has recognized, even if a basic customer does not choose to avail itself of these new service offerings, system upgrades result in improvements in reliability and signal quality that basic customers enjoy and indeed demand.[26] The FCC rules take into account the fact that not all upgrade costs should be paid by basic ratepayers, but it appropriately permits allocation of a fair share to the BST.

NATOA takes issue with allowing operators to recover even their fair share from basic customers. Its Report tries to attack the methodology for allocating upgrade costs in a variety of ways. But an examination of these claims shows no justification for the "substantial overhaul"[27] that NATOA proposes. NCTA will not respond to every misapprehension incorporated in the NATOA Report. Instead, the following discussion illustrates by example some of the facial inconsistencies between NATOA's proposals and the FCC's governing rules and policies.

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[25] NATOA Report at 8.

[26] *Cox Communications San Diego, Inc. (Chula Vista, CA)*, 13 FCC Rcd 17653, 17657 at ¶¶ 8-9 (Cab. Serv. Bur. 1998) ("[s]ubscribers are presumed to benefit from improved service quality and reliability when an operator meets the minimum technical specifications").

[27] NATOA Report at 9.

A. The Commission's Rules and the GAAP Matching Principle Prohibit the Offset of BST Costs with Non-BST Revenues.

NATOA argues that revenues from non-BST channels and from channels carried prior to a system upgrade should be used to offset upgrade costs properly allocated to the BST on FCC Form 1235.[28] However, those arguments are contrary to the Commission's precedents and long-standing cost allocation rules as well as the GAAP matching principle with which cable operators are required to comply.[29]

That precedent provides that cable operators are not required to offset rate increases for one channel with increased revenue from a different channel or service tier.[30] The Commission also has specifically declined to require that advertising revenues be used to offset external costs.[31] Moreover, in its cost-of-service proceeding, the Commission reiterated the fundamental principle that costs and revenues should be directly assigned wherever possible, and required that costs and revenues be assigned either to the equipment basket, the basic service tier, the cable programming service tier, unregulated services, other cable activities (leased access services, *etc.*), and non-cable activities.[32] When it created the Form 1235,

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[28] *Id.* at 21. NATOA also speculates that cable operators may earn more than the Commission's 11.25% regulated rate-of-return on non-BST services made possible by a system upgrade and suggests that the Commission should change its rules either to require that such non-BST revenues be offset against *bona fide* BST upgrade costs or to eliminate the streamlined network upgrade option entirely. *Id.*, at 8-9.

[29] Under the Commission's accounting requirements, cable operators must maintain their accounts "in accordance with generally accepted accounting principles," 47 C.F.R. § 76.924(b)(1), and must directly assign programming costs and revenues "only to the service cost category in which the programming or broadcast signal at issue is offered," 47 C.F.R. § 76.924(f)(2).

[30] *See, e.g.*, 47 C.F.R. § 76.922(f)(7) ("Such adjustments shall apply on a channel-by-channel basis"); *Rate Order*, 8 FCC Rcd at 5789, n.602; Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *Sixth Order on Reconsideration, Fifth Report and Order, and Seventh Notice of Proposed Rulemaking*, 10 FCC Rcd 1226, ¶ 74 (1994) (revenues received from programmers offset against programming costs and per-channel adjustments on a channel-by-channel basis), *aff'd Adelphia Communications Corp. v. FCC*, 88 F.3d 1250 (D.C. Cir. 1996)).

[31] Although system advertising revenues would be considered in an overall cost-of-service showing, *see Rate Order*, 8 FCC Rcd at 5788-89 and n.602, neither programming costs nor advertising revenues received from channels not added as a result of the system upgrade are reflected in an FCC Form 1235, which, as NATOA admits, "only addresses the new rate bases and expenses associated with the upgrade, and not all of the underlying costs." NATOA Report at 7.

[32] *Cost Order*, 9 FCC Rcd at 4651-52, ¶ 238. Because the Commission subsequently determined that this allocation scheme "would be overly burdensome to continue," it removed the requirement that non-regulated

(*continued . . .*)

therefore, the Commission was fully aware that the provision of new unregulated services would be a significant incentive for system upgrades, and designed its rules to ensure that upgrade costs would be fairly allocated among regulated and unregulated services in accordance with GAAP. NATOA's proposals to offset BST costs with non-BST revenues and to subsidize BST upgrade costs with revenue from channels carried prior to implementation of the system upgrade conflict with these fundamental principles.

The Commission also has consistently confirmed that the only projected advertising revenue properly reflected on FCC Form 1235 is revenue from channels added as a result of the upgrade.

In *Mountain Cable*, for example, the Commission held that:

> Costs of any programming added to the BST as a result of the upgrade are directly allocated to the BST, and the only upgrade related programming revenues allocated to the BST are revenues derived from channels added to the BST as a result of the upgrade. Costs and revenues attributable to programming on other service tiers would be allocated to the tier on which the particular programming is added. While Form 1235 asks for information about projected CPST and other revenues, revenues directly allocated to those categories would not affect the BST rates subject to the [LFA's] jurisdiction and are not subject to the [LFA's] review. Because determining the revenue requirement for the BST does not depend on information about revenues from advertising or home shopping commissions for channels added to the CPST or carried on a premium basis, denying a BST network upgrade add-on for failing to show revenues directly generated by non-BST channels is not reasonable.[33]

(. . . *continued*)

costs be assigned to "specific non regulated service categories," and established that costs must be allocated among "the equipment basket and the following service cost categories: (1) BST, (2) CPST, and (3) all other." Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, *Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking* ("*Final Cost Order*"), 11 FCC Rcd 2220, 2268-70 at ¶ 119 and ¶ 121 (1996). The Commission also clarified that "revenues must be matched with underlying expenses." *Id.*, 11 FCC Rcd at 2268, ¶ 119.

[33] *Mountain Cable d/b/a Adelphia Cable Communications, Inc.*, 14 FCC Rcd 11807, 11817 at ¶ 22 (Cab. Serv. Bur. 1999).

In *Falcon Cable Systems*, the Commission similarly rejected an LFA's attempt to offset BST costs with non-BST advertising revenues in an FCC Form 1235:

> Although the LFA argues that advertising revenues increased significantly immediately after the upgrade was completed, it has not demonstrated that the increased advertising revenues are specifically attributable to the added channels. . . . Because Operator is not able to derive any revenue from the ad avails on the added channels, and does not plan to derive any revenue, we find the LFA's inclusion of projected advertising revenues to be unreasonable.[34]

In *Marcus Cable Associates*, the Commission also re-assigned an operator's FCC Form 1235 revenue and income adjustments from the BST to the CPST because:

> all of Operator's revenue and income adjustments represented advertising revenues that will accrue under the upgrade. Because nearly all advertising time is concentrated on the CPST, and to properly match the revenues with corresponding expenses in accordance with the matching principle under Generally Accepted Accounting Principles ("GAAP"), we reassigned Operator's revenue and income adjustments directly to the CPST.[35]

Contrary to NATOA's contentions, therefore, the Commission's rules and precedents properly require that only additional ancillary revenues from new channels added as a result of the upgrade are to be included on FCC Form 1235.[36] This approach is consistent with GAAP, which requires that cable operators match upgrade related revenues with upgrade related expenses.

NATOA offers no plausible reason for the Commission to abandon these well-established rules and precedents so that non-BST and non-upgrade related revenues will offset BST upgrade costs imposed by LFAs or otherwise incurred by cable operators. The Commission consequently should summarily reject NATOA's proposals that revenues from

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[34] *Falcon Cable*, 14 FCC Rcd at 2109, ¶ 10 (Cab. Serv. Bur. 1999).

[35] *Marcus Cable Associates, L.P. (City of Glendale)*, 13 FCC Rcd 9012, 9020 at ¶ 21 (Cab. Serv. Bur. 1997).

[36] *See also* FCC Form 1235 Instructions for Worksheet A, Line 10 (cable operators should "[i]nclude the projected annual net increases or decreases in ancillary revenues earned *due to the implementation of the upgrade*, such as . . . advertising revenues and commissions. . . . [and should] allocate such amounts to regulated service cost categories if such revenues are associated with program offerings on regulated channels." FCC Form 1235 Instructions at 11 (emphasis added).

non-BST channels and from channels carried prior to a system upgrade should be used to offset upgrade costs properly allocated to the BST.

B. The Commission's Rules and the Principle of Cost Causation Require that Plant Costs not Directly Assignable to a Specific Tier be Allocated Among Tiers Based on a Straight Channel or Bandwidth Ratio.

As explained above, the Commission's rules and precedents require cable operators to directly assign costs and revenues on a cost causative (service tier or per-channel) basis wherever possible and similarly to match costs and associated revenues.[37] Where common costs cannot be directly assigned, the Commission's rules and precedents require that cable operators allocate the cost of a network upgrade among various service tiers based upon the bandwidth required for the channels carried on each of those tiers.[38]

NATOA argues that the Commission should abandon the cost-causative allocation methodology adopted in the *Rate Order* and the *Cost Order* and instead implement a weighted allocation rule. While acknowledging the validity of a bandwidth allocator, NATOA suggests that allocation of upgrade common costs be weighted based on "the relative number of 6 MHz channels dedicated to each tier" and the "number of incremental 6 MHz channels added to the system."[39] The Commission, however, has consistently rejected the use of weighted allocation methodologies for rate regulation purposes because it would "create[] a bias . . . when, in fact, plant usage is most often directly attributable to the number of channels supported."[40] With regard to the FCC Form 1235 in particular, the Commission specifically rejected LFA arguments that "more costs should be assigned to added channels than existing channels."[41] NATOA offers no explanation of how its weighted allocation scheme would work in practice

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[37] *See, e.g.*, *Cost Order*, 9 FCC Rcd at 4651-51, ¶ 238; *Final Cost Order*, 11 FCC Rcd at 2268, ¶ 119.

[38] *See* 47 C.F.R. §§ 76.922(j)(4); 76.924(f). *See also Cost Order*, 9 FCC Rcd at 4653-54, 4676.

[39] NATOA Report at 22.

[40] *See, e.g.*, *Final Cost Order*, 11 FCC Rcd at 2271, ¶ 123.

[41] *Falcon Cable*, 14 FCC Rcd at 2108, ¶ 9 ("The LFA argues that, in addition to providing improved quality and reliability, the upgrade adds capacity and that more costs should be assigned to added channels than existing channels. We find the LFA's adjustment to be unreasonable . . . .").

and, not surprisingly, provides no authority for its position. The Commission should reject it as inconsistent with underlying rate regulation principles.

The FCC has held repeatedly that the recovery of upgrade costs properly allocated to the BST does not depend on the addition of new channels to the BST.[42] However, because "[t]he cost of physical plant is directly related to the provision of cable channels and the amount of channel capacity a particular system has,"[43] the FCC found that "a straight channel ratio would be a reasonable approach to the allocation of plant costs amongst service baskets."[44] Pursuant to the Commission's cost allocation rules, therefore, cable operators only allocate to the BST upgrade costs that cannot be directly assigned to a specific service tier on Worksheet B of the FCC Form 1235.[45] Costs that cannot be directly assigned consequently are allocated in part to the BST based upon the ratio of spectrum used for BST channels to the upgraded system's total capacity using 6 MHz of capacity per channel.[46] In the usual case where a cable operator adds only CPST or other non-BST channels as a result of an upgrade, a proportionately larger share of common upgrade costs are already allocated under the FCC's formula to non-BST cost categories and are not borne by BST customers.[47] Therefore, only a small portion of upgrade costs that cable operators incur are reflected in regulated rates in any event.

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[42] *See, e.g., Cox Communications*, 13 FCC Rcd at 17658-59, ¶ 15.

[43] *Final Cost Order*, 11 FCC Rcd at 2237.

[44] *Id.*, 11 FCC Rcd at 2270, ¶ 123; *see also Falcon Cable*, 14 FCC Rcd at 2108-09, ¶ 9.

[45] *See* 47 C.F.R. § 76.924.

[46] For example, an upgraded cable system with 750 MHz total activated capacity that uses 180 MHz of that capacity for BST channels would allocate to the BST twenty-four percent (24%) of upgrade costs that cannot otherwise be directly assigned to a specific tier (180 ÷ 750 = 0.24).

[47] NCTA observes that an LFA's jurisdiction is limited by federal law to rates for BST service and associated equipment and installations calculated pursuant to the Commission's regulations. 47 U.S.C. § 543. Questions related to other tiers or services consequently are irrelevant to the FCC Form 1235. Moreover, "Section 76.924(f)(7) [of the Commission's rules] allows the operator [rather than the LFA] flexibility in determining specific allocators and allocation schemes that achieve reasonable results when direct allocation is not possible." *Mountain Cable*, 14 FCC Rcd at 11814, ¶ 16 (footnote omitted, citing *Cost Order*, 9 FCC Rcd at 4653-54; *Final Cost Order*, 11 FCC Rcd at 2268).

The Commission's existing cost allocation rules fairly allocate common upgrade costs that cannot be directly assigned to a specific service tier among the various tiers in proportion to the number of channels or bandwidth used by each tier and its precedents consistently have rejected weighted allocation schemes such as that proposed by NATOA. The NATOA Report provides no justification for abandoning these sound methods for cost allocation established in the Commission's rules and incorporated in the FCC Form 1235.

C. Embedded Capital Costs.

NATOA also argues that the FCC Form 1235 allows cable operators to over-recover upgrade costs by including "the full amount of the incremental upgraded investment without first removing the embedded investment that has been replaced."[48] However, the Commission's rules and the FCC Form 1235 already fully account for embedded costs and allow only for the recovery of upgrade investment net of retired assets.

The Commission concluded in the *Cost Order* that "the cost of premature abandonments should be a recoverable operating expense rather than an element in the rate base," and allowed cable operators to amortize any unrecovered investment over the remaining original life of a retired asset.[49] The Commission specifically designed its rules to protect subscribers by "precluding recovery of a rate of return on abandoned plant while preserving an opportunity for the cable operator to invest in more advanced technology."[50]

Contrary to NATOA's contention, the FCC Form 1235 Instructions already require, among other things, that upgrade rate increases may include only "the actual costs of the capital investment, less any gains realized from the disposition of property, plant and equipment used prior to the upgrades."[51] NATOA's position also ignores and is contradicted

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[48] NATOA Report at 15.

[49] *Cost Order*, 9 FCC Rcd at 4675, ¶ 119.

[50] *Id.*

[51] FCC Form 1235 Instructions at 1; *see* FCC Form 1235 Worksheet A and Part II.

by the Commission's FCC Form 1235 precedents, which uniformly have held "that any gains realized from the disposition of property, plant, and equipment used to provide network services are to offset the cost of the capital improvement in the rate-making process."[52]

The Commission's rules and the operation of FCC Form 1235 already fully account for any "embedded investment that has been replaced by new plant."[53] The NATOA Report is based upon an apparent misunderstanding of the Commission's rules and its embedded cost argument is not cause for revising the form.

D. Income Taxes.

NATOA's contentions regarding the treatment of federal and state income taxes on FCC Form 1235 similarly are misplaced and are based upon two equally erroneous assertions. First, NATOA argues that the Commission's FCC Form 1235 methodology is deficient with regard to the interest component of the income tax allowance because it "does not follow the same methodology used in the [FCC Form] 1205."[54] Second, NATOA claims without support or evidence that "operators do not include interest expense [in the income tax allowance calculation] under the pretext that the operator has not incurred any new debt associated with the upgrade."[55] Both assertions are incorrect.

In fact, the FCC Form 1235 Instructions describing the Income Tax Allowance are substantively identical to those in the FCC Form 1205.[56] Both require that relevant interest expense be deducted from the return amount subject to income tax so that the deductibility of interest is reflected properly in the calculation.[57] Both also use precisely the same calculation

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[52] *Mountain Cable*, 14 FCC Rcd at 11815, ¶ 18 (footnote omitted, citing FCC Form 1235 Instructions at 1); *see also, e.g., Falcon Cable*, 14 FCC Rcd at 2107, ¶ 7.

[53] NATOA Report at 15.

[54] NATOA Report at 17.

[55] *Id.*

[56] *Compare* FCC Form 1235 Instructions at 6-7 (Line 3.) *with* FCC Form 1205 Instructions at 8-10 (Schedule A, Line G).

[57] *Compare* FCC Form 1235 Instructions at 7 (Line 3.g.) *with* FCC Form 1205 Instructions at 8-9 (Schedule A, Line G4). After allocation to the appropriate service cost category, "Interest Expense Related to [the]

(*continued . . .*)

to determine the income tax allowance.[58] Therefore, NATOA's contention that the FCC Form 1235 is deficient because it uses a tax gross-up methodology that differs from the FCC Form 1205 has no basis in the forms.

With regard to NATOA's unsupported assertion that cable operators deliberately exclude interest expense from FCC Form 1235 filings, the Commission should note that beyond NATOA's mere *ipse dixit*, it offers neither authority nor evidence of any kind to bolster its claim.

E. Programming Costs.

NATOA claims that in FCC Form 1235 filings "a direct assignment of programming costs to each individual tier is simple but is easily subject to abuse when the operator must apportion the distribution plant among service tiers."[59] Beyond this unsupported assertion, however, NATOA does not explain or otherwise provide evidence of the "abuse" to which it refers. Moreover, the FCC Form 1235 is a supplemental filing supporting specific capital costs associated with significant system upgrades and is submitted in conjunction with a benchmark rate justification. Contrary to NATOA's claim, therefore, the FCC Form 1235 does not reflect programming costs, which instead are specifically accounted for as external costs in the operator's associated FCC Form 1210 or FCC Form 1240 benchmark rate filing.

Programming costs have no relation to the calculation of the network upgrade rates pursuant to FCC Form 1235, which is designed solely "to justify rate increases related to significant capital expenditures used to improve rate-regulated cable services. . . . [and] only

(. . . *continued*)
Upgrade for debt acquired for the completion of the upgrade," FCC Form 1235 Instructions at 6 (Line 3.d., emphasis omitted), is subtracted from the Return Amount Subject to Income Tax before the Income Tax Allowance is applied, FCC Form 1235 Instructions at 7 (Line 3.g.).

[58] The FCC Form 1235 and the FCC Form 1205 both compute the tax gross-up rate as follows: [(Federal Income Tax Rate + State Income Tax Rate) – (Federal Income Tax Rate * State Income Tax Rate)] /1 – [(Federal Income Tax Rate + State Income Tax Rate) – (Federal Income Tax Rate * State Income Tax Rate)]. *See* FCC Form 1235 Instructions at 7 (Line 3.h.); FCC Form 1205 Instructions at 8-10 (Schedule A, Line G).

[59] NATOA Report at 7.

for significant upgrades requiring added capital investment, such as band width capacity and conversion to fiber optics, and for system rebuilds."[60] The FCC Form 1235 consequently provides no entry for programming costs.[61]

In contrast, the Commission's rules specifically define programming costs as external costs that are reflected on Worksheet 7 of the FCC Form 1240.[62] Cable operators generally include all BST programming costs in their FCC Form 1240 filings, and those costs therefore are not reflected in the FCC Form 1235. Moreover, as NATOA is aware, in most cases no channels are added to the BST as a result of an upgrade, and consequently no programming costs would be relevant to the FCC Form 1235 in any event. "Section 76.924(f)(2) of the Commission's rules specifically provides that programming costs are directly assigned or allocated only to the service cost category in which the programming at issue is offered. Costs of any programming added to the BST as a result of the upgrade are directly allocated to the BST [in the FCC Form 1240], and the only upgrade related programming revenues allocated to the BST are revenues derived from channels added to the BST as a result of the upgrade."[63]

Contrary to NATOA's claim, the Commission's existing rules fully account for programming costs in the benchmark rate filings for which the FCC Form 1235 provides an upgrade cost supplement, and the unspecified abuse referred to by the NATOA Report simply cannot exist.

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[60] FCC Form 1235 Instructions at 1.

[61] *Id.* The FCC Form 1235 Instructions also make clear that programming costs should not be reflected in the Form. For example, in reflecting Operating Expenses, the Instructions specify that operators should include only "the present value of projected net increases or decreases in salaries, wages, and benefits expense for laborers, technicians, and their supervisors involved in the construction, maintenance, testing and operation of headend, trunk and distribution facilities, drops, and customer premises facilities related directly or indirectly to the capital improvement upgrade over its estimated useful life."[61] Similarly, in reflecting Support Expenses, operators are instructed to include only "net increases or decreases in salaries, wages, and benefits' expenses of employees engaged in plant support operations including the maintenance of buildings, vehicles, tools and equipment, the warehousing and provisioning of supplies, and other such support operations directly or indirectly related to the upgrade. . . . including power, fuel, supplies, rental of poles, rental of ducts, and other such rental items, except for depreciation and general administrative overhead expenses."

[62] 47 C.F.R. § 76.922(f)(1)(v); FCC Form 1240 Instructions at 2, 3, 35.

[63] *Mountain Cable*, 14 FCC Rcd at 11817, para.22.

F. Projected Costs and Timing of Review.

NATOA advances several related arguments that focus on speculative changes in operating costs over the useful lives of the upgraded facilities reflected in FCC Form 1235. These arguments lead to various NATOA proposals, including conversion of the Commission's one-time, streamlined network upgrade option into a burdensome annual cost-of-service proceeding replete with unsupported presumptions that cable operators would be required to rebut annually.[64] This proposal would fundamentally undermine the reasons for permitting a streamlined cost of service filing.

As demonstrated above, the Commission designed its streamlined network upgrade option to "to implement the goals of the Cable Act of 1992, to promote the availability of diverse cable services and facilities, encourage economically justified upgrades, and reduce regulatory burdens, while ensuring reasonable rates for regulated cable services."[65] In doing so, the Commission implemented congressional directions by reducing the administrative burdens of incorporating justified upgrade costs in regulated cable television rates and succeeded in providing a treatment of net upgrade expenses similar to external treatment without requiring an overly burdensome full cost-of-service showing. At the same time, the Commission balanced the costs of LFA-mandated system upgrades[66] with reasonable rates by, among other things, limiting applicability of the FCC Form 1235 to only "significant upgrades

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[64] *See* NATOA Report at 7 ("overall revenue requirements are not properly adjusted in future periods because the cost of service in that future period will change, but the amount of the Form 1235 rate increase will not change accordingly"); *id.* at 10-12 (arguing that revenue requirements decline over time); *id.* at 19 (arguing that the FCC should presume a ten percent reduction in operating costs and support expenses); *id.* at 23-24 (arguing that cable operators should "be required to file either the projected or final 1235 filing annually over the useful life of the upgrade, along with the operator's annual 1240 filing").

[65] *See supra*, n.16 and accompanying text; Cost *Order*, 9 FCC Rcd at 4674-75, ¶ 285.

[66] As the Commission is aware, in the franchising and franchise renewal process LFAs commonly require "gold-plated" cable system upgrades or rebuilds in one form or another. Indeed, one of the most common provisions found in cable television franchise agreements is the requirement that the operator maintain a "state-of-the-art" system, which often is accompanied by periodic local review requirements that may require system upgrades at specified times during the franchise term. The Cable Act permits LFAs to require system upgrades in franchise renewal negotiations. *See* 47 U.S.C. § 546(b)(2).

requiring added capital investment, such as band width capacity and conversion to fiber optics, and for system rebuilds."[67]

In contrast, NATOA's proposals to transform the Commission's streamlined network upgrade option into a full-blown annual cost-of-service proceeding are irreconcilable with governing congressional and Commission policies. Among other things, NATOA's proposals likely will engender numerous appeals of local rate orders before the Media Bureau and will thereby impose undue burdens on the Commission and on cable operators. NATOA's proposals also present obvious opportunities for abuse as LFAs may attempt to impose substantial upgrade or rebuild costs on one hand while attempting to prevent associated rate adjustments created by those costs on the other.

NATOA's proposals also ignore the purpose and function of the FCC Forms 1235, 1240, and 1205. As the Commission repeatedly has acknowledged, the FCC Form 1235 is a one-time filing that supplements an operator's benchmark FCC Form 1240 and FCC Form 1205 filings.[68] It determines only an incremental cost-of-service revenue requirement based on the added investment and related expenses resulting from a significant system upgrade, and therefore reflects only specific and limited costs the operator has already incurred and that will not change in future periods. It also accounts for projected cost savings resulting from the upgrade and allows cable operators the ability to recover the net upgrade expenses in regulated rates as a uniform add-on to the benchmark rate calculated in FCC Form 1240 over the useful life of the facilities constructed for the upgraded cable system. Annual future increases and decreases in the costs and expenses associated with the provision of regulated cable services,

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[67] FCC Form 1235 Instructions at 1; *Cost Order*, 9 FCC Rcd at 4674-76. In this manner, the Commission gave LFAs some measure of control over rate increases because "[l]ocal authorities presumably are in a position to weigh the potential impact of any cost increases on subscribers at the time they require system changes." *First Reconsideration Order*, 9 FCC Rcd at 1216, n.160.

[68] *See, e.g., Time Warner Cable (Durham, NC)*, 19 FCC Rcd 14851, n.10 (Med. Bur. 2004) ("the [Form 1235] network upgrade add-on is not recomputed or re-approved each year that it is available"); *Marcus Cable Associates, LP (Ft. Worth, TX)*, 14 FCC Rcd 7174, n.15 (Cab. Serv. Bur. 1999) ("only one FCC Form 1235 is to be filed following the completion of the upgrade project") (citing FCC Form 1235 Instructions at 1-2).

equipment, and installation are incorporated in and reflected by the FCC Form 1240, in the case of cable service, and the FCC Form 1205, in the case of customer premises equipment and installations.[69]

Given the Commission's existing rate regulations, therefore, NATOA's proposals to require annual cost-of-service filings for system upgrades and periodic adjustment of upgrade related system expenses and revenue requirements are not only unduly burdensome but also wholly unnecessary.

[69] Even the Commission's full-blown cost-of-service rules do not require annual FCC Form 1220 filings; indeed, annual cost-of-service showings are prohibited and subsequent rate adjustments generally are implemented using FCC Form 1240. *See* 47 C.F.R. § 76.922(i).

Conclusion

For the foregoing reasons, the Commission should adopt the limited procedural refinements reflected in the Cox Comments, otherwise maintain the Commission's streamlined network upgrade option, and reject NATOA's proposals.

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December 14, 2004

CERTIFICATE OF SERVICE

I, Sandy Dallas hereby certify that on this 14th day of December, 2004 I caused the foregoing Reply Comments of the National Cable & Telecommunications Association to be served by first-class mail, except where hand delivery is indicated, on the following:

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